DR. KURT RICHEBÄCHER

CURRENCIES AND CREDIT MARKETS

No. 249 / January 1994

"It is not so much the folly of the ordinary man who played the market during the stock exchange boom as the folly of those to whom he looked for advice and guidance which is most striking. Many were of course personally interested in the continuation of the Bull Market."

The Great Slump, Goronwy Rees, p.22
Weidenfeld and Nicholson, 1970.

HIGHLIGHTS

As the new year begins, global financial markets continue to boom manically. The most crucial question is this: Is the boom a treacherous financial mania or a sustainable, healthy development?

Peering into the uncharted waters of 1994, the most critical issue for investors is whether or not the U.S. economy is breaking out of its slow-growth, roller-coaster growth pattern of the past 3-4 years and launching into a self-feeding dynamic phase, leading a global recovery.

What's different with this latest economic surge? We have scrutinized the current U.S. economic recovery again in great detail. The conclusion of our study? We expect that U.S. economic growth will decelerate sharply to a virtual crawl in the coming months.

Neither in the United States nor anywhere else do we see convincing evidence of a sustainable economic recovery. While downturns will level off, the world economy is likely to get weaker.

To Wall Street, the current financial boom has a healthful origin in the prolonged coincidence of low inflation, slow economic growth and very easy money. To their way of thinking, what's occurring is a perfectly sound "liquidity-driven" boom. We show why the exact opposite is true.

Every speculative era is marked by some new novel theory. We examine some of the ones of past bubble eras. All of them proved to be false. Upon detailed analysis of present new-fangled yarns, we conclude that the same fate awaits these also.

Actually, what's unfolding in the financial markets is an unprecedented stampede away from liquidity. That's the key to unravelling the monetary mystery of how a financial mania can take place within an environment of broad money stagnation.

There is a severe downside to this portfolio shift: holdings of individual's liquid assets today have fallen steeply as a share of total financial assets. Ominously, overall liquidity (M4) is now the lowest in history as a share of total debt. There is only so much money that can shift.

Sadly, we see a deceptive process under way that's luring investors into certain financial disaster.

Investors will be fortunate to preserve their money in 1994. Investment prospects are beginning to look skimpy everywhere. Investors should avoid overspeculated markets at all costs. It's best to focus on short-term cash securities and shorter-term bonds of the hard currency countries.

HARD FACTS VERSUS DREAMS

No matter what one's views, last year was full of surprises and disappointments. What developed was a picture of unprecedented contrasts: continuing economic attrition and hardship alongside booming financial markets around the world. As the new year begins, stock markets and most bond markets are in a fever-pitched frenzy of euphoria and speculation. And again, the jungle drums are beating out the message that the U.S. economy has entered an accelerating recovery, the fourth time in as many years.

Yet, reviewing economic growth and employment, 1993 was an unmitigated disaster. Gauging by these measures, it was the most depressed year ever recorded for the industrial countries according to the Organization for Economic Cooperation and Development (OECD). For all of its member countries combined, real GDP growth is estimated to have been only around 1%, in sharp contrast to earlier forecasts of 2.5%. The sources of the unexpected weakness were Europe and Japan. Will the clouds finally lift in 1994, either financially or economically?

We don't want to be spoil-sports just to be contrarians. But, unfortunately, we still see continuing problems and, above all, huge and ballooning risks related to a fast-expanding financial bubble. We are very aware that we are a lone voice with our warnings. It's at times like this when we find ourselves in a smaller minority than usual that we are prompted to redouble our research activities and check the numbers twice. Because of that, we especially ask our readers to bear with us in this letter since we will be digging into statistics more than usual. We want to cut through the dreams and focus on the hard facts.

THE KEY ISSUES

Peering into the unknown waters of 1994, the most crucial and important issue for investors is whether or not the U.S. economy is breaking out of its slow-growth, roller-coaster pattern and launching into a self-feeding dynamic phase. Lately, there's been a horde of economists announcing the beginning of just such a phase. If it happens, it certainly would help lead a world recovery — a desirable development.

True, compared to the low growth rates of the rest of the industrial world, U.S. economic growth in 1993 — probably ringing in at 2.8% or so — indeed appears imposing. Unfortunately, this strength is only relative. Such a superficial comparison overlooks the absolute weakness of the U.S. recovery. Despite the Fed's vigorous money pumping and interest rate cuts — efforts begun years earlier than most other countries — it has yet to succeed in igniting a self-sustaining recovery.

Nevertheless, the U.S. stock and bond markets have starkly underperformed other world markets. Financial speculation has shifted heavily towards Europe and the Far East. Rather oddly, U.S. stocks have been the laggard of global markets, rising only 7%. By contrast, European stocks soared an average of 24%. Star performers were the Far East stock exchanges with an average gain of 81% (ex. Japan).

The most crucial question is this: Is this long financial boom a treacherous financial mania or a sustainable, healthy development?

THE AMERICANIZATION OF GLOBAL FINANCIAL MARKETS

Why have European stocks taken off? Two predictions appear to have supplied the rocket fuel — although somewhat contradictory and overblown to us: expectations of further sharp falls in interest rates and an impending cyclical recovery. If either one should happen, the other is unlikely. But never mind. Conforming to the U.S. pattern, it is widely taken for granted that the Bundesbank will rapidly slash rates

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CURRENCIES AND CREDIT MARKETS

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ERRATUM NOTICE

Dear Reader,

A last-minute production glitch caused a serious error on page 3 of the January 1994 letter. The two paragraphs under the first headline should have read as follows:

IS THE WORST BEHIND?

Overall, the consensus thinks that the worst of the world recession is over and that, generally, things can only get better. A great sense of confidence has emerged on the evidence of recent growth stirrings in the United States, Canada, Britain and Australia. Given this flow of warm feelings in recent months, the mood is to wager modest growth pick-ups in Continental Europe and Japan, as well.

Brazened by this new faith in the powers of low interest rates, an unprecedented chasm has opened up between miserable economic and financial fundamentals — poor profits, low savings and record-sized budget deficits — and celebrant financial markets. Most brokerage and bank reports spin a delightful tale of marvellously improving fundamentals and the promise of a new economic and financial age.

We sincerely apologize for any confusion this may have caused.

from the present 6% level down to 3%, paving the way for corresponding cuts everywhere else in Europe. These interest rate forecasts, in turn, give rise to predictions of impending economic recovery for Europe. Happily, the high-flying stock markets seem to be discounting both.

We have great difficulty in reconciling these assumptions. Firstly, we don't think the Bundesbank will comply. As opposed to the Fed, it is hardly likely to slash short-term interest rates to levels below the inflation rate. Besides, the Bundesbank is much more sceptical about the effectiveness of interest rate cuts in stimulating economic output than U.S. policymakers and economists are. As a matter of fact, this scepticism is widely shared throughout all of Europe though the Bundesbank serves as the scapegoat.

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Our main dissent from the consensus view, however, concerns the near- and medium-term prospects of the world economy in general and the U.S. economy in particular. To us it appears that false optimism about the U.S. economy has been translated into an optimistic dream about the world economy. That must sound like heresy given the apparently unarguable surge of bullish economic statistics out of the U.S. during recent months. However, we are guided by hard facts. Thorough investigation reveals important information that supports our view.

NEW AGE VERSUS OLD THEORY

Is it time to revise our highly critical view of the world financial boom and the U.S economy? Are we simply outdated . . . or are we missing something? To answer this question, we undertook a most comprehensive and thorough investigation of U.S. economic, financial and monetary conditions. In contrast to the outbreak of optimism everywhere else, this analysis has deepened our scepticism.

Searching the history books and reviewing theory for guidance, we discovered that all financial manias have occurred at times of low inflation . . . or at least, apparent low inflation. Economic growth during these periods more usually was sluggish. While that may be perplexing, the real linkages to a financial mania are of course the associated loose monetary policy and extremely low interest rates.

Thus, the stock market boom in the 1920s was stoked by the slogan of a "new era" of permanent price stability. Consumer prices were in 1929 no higher than in 1922. During the 1980s, the battle cry of the financial speculators was "disinflation." Correspondingly, the current run-up in stock and bond prices is widely seen as a natural corollary of low and falling inflation and interest rates.

"New Wave" and "New Economy" are some of today's euphemisms for a new golden age. The essence

of all these theories is that some new principle applies today that wasn't operative ever before. Perpetually low inflation and low interest rates we are told — rather than rising incomes and dividends — should be reasonably expected to drive up financial asset valuations to unprecedented levels. Or, an explosion of "knowledge based industries" will be the new growth engine of economic growth and productivity of the future. We want to investigate the basis of these theories.

The connection between inflation and interest rates is certainly much looser than markets think presently. There is a host of other factors that determine interest rate levels. Yet it's a fact that low inflation tends to be regarded in America and some other countries as a key barometer of economic excellence and health. Oddly, in some countries it tends to mislead policymakers into excessive monetary ease.

MARKETS AND THE ENIGMA OF LIQUIDITY

For Wall Street and the City of London, the current financial boom has its healthy origin in the prolonged coincidence of low inflation, slow economic growth and very easy money. As a result — so the cheerful conclusion — surplus money has nowhere else to go but into the securities markets. To this way of thinking, what is happening is a perfectly sound "liquidity-driven" boom.

In reality, it's neither sound nor "liquidity-driven." This parlance came into use during the mid-1980s when the economy slowed while broad money continued to forge ahead. The argument then was that "excess liquidity" essentially had to flow into financial markets therefore buoying financial values. Between 1983 and 1986, total nominal GDP growth of 24.2% coincided with greater broad money (M2) growth of 28.6%. Actually, this experience had a famous parallel in the 1920s stock market boom. Between 1923 and 1928, U.S. GDP rose 21% and bank deposits (the closest equivalent to M2 of that day) by 32%. However, later in 1928, money growth stopped.

Today, again as in the mid-1980s, there's a dichotomy between economic sluggishness and financial bullishness . . . only this time it's greater than ever. So, the ready, convenient explanation is that a vast "excess" of "liquidity" is pouring into the markets. But apparently, nobody must be bothering to check this explanation, because the truth is precisely the opposite.

BROAD MONEY IS THE KEY

In general, broad money (except in Germany and most of the Asian countries) has been growing at its slowest pace on record. It is sharply and progressively falling short of economic growth. For example, since 1990, U.S. nominal GDP has expanded a cumulative 15.3% while M2 and M3 have grown only 5.2% and 1.4%, respectively. That's no "liquidity surplus." What we see is the biggest "liquidity gap" of all time. Clearly, something else must explain this financial boom.

True, various monetary aggregates — bank reserves, the monetary base (made up of bank reserves and currency) — have been expanding at a record pace. By the light of these measures of money — which happen to be favoured by the American monetarists — there is a rampant supply of liquidity.

THE EUROPEAN MONEY VIEW VERSUS THE MONETARIST

Now we come to some key conceptual differences between American monetarism and traditional European money and credit theory. According to the latter camp, the kind of liquidity that's most important for

economic activity are not the bank reserves or the monetary base but the liquid assets in the hands of businesses and consumers. What good is liquidity in the coffers of banks if it's not being redeployed in the real economy? What best measures the liquidity of businesses and consumers is bank deposits and the broad money aggregates (M2, M3, M4).

If monetarists are asked what the precise mechanism is that translates changes in bank reserves or the monetary base into a real economic impact, they have no answer. The widely accepted Friedmanite view (originated by Milton Friedman) is that the transmission process is so difficult to trace that one should instead pursue the statistical route of searching for monetary aggregates that show the most stable correlation with income. And that's what American monetarism mainly is — statistics.

European money and credit theory is mainly preoccupied with the search for causal links between money, credit and the economy. Associated with that is a distinct contempt for the value of statistics in understanding these processes. To quote Joseph L. Schumpeter on this point: "*No proof is ever possible by statistics alone.*" Ludwig von Mises, too, had a deep distrust of statistics being convinced that there were no such thing as a durable statistical relationship.

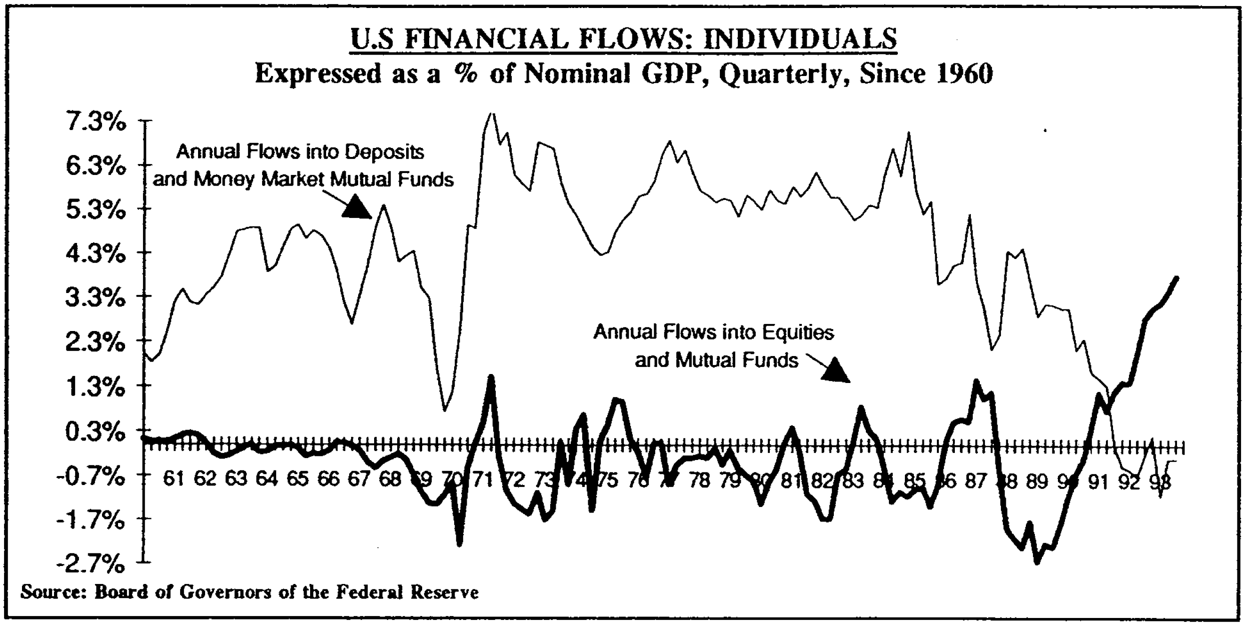
Taking the European view, liquidity creation is a two-step process. The first step involves the central banks. Their purchases of bonds creates liquidity. However, to this point, it's only bank liquidity. Whether or not this increased liquidity translates into higher business and consumer spending depends entirely on the joint response of the banks and their customers. The growth of money (mostly bank deposits) in the hands of businesses and consumers essentially involves the expansion of bank credit.

At its roots, European theory is basically credit theory. Its guiding principle is that any economic expansion is reliant upon money and liquidity created by the commercial banks to the credit of businesses and consumers. That's what is reflected in broad money growth. How has broad money fared over the past few years? As we've already pointed out, broad money has been weak almost everywhere. Over the past three years in the U.S., M2 has grown at an average annual rate of 1.8% and M3 at 0.7%. This compares with average annual broad money growth of approximately 10% during past cyclical recoveries. Seen in this light, the Fed's easing, though most aggressive, is a complete fiasco in terms of generating liquidity and activity in the real economy.

THE SOURCES OF THE BUBBLE

Still, the fact is that there are the booming financial markets. For most observers, that's taken as "point-blank" evidence that there is vast supply of excess liquidity. But, that's dead wrong. When assessing the sustainability of money flows into the securities markets, we need to distinguish between three different sources: 1. current savings, 2. new money creation — current flows, in other words — and 3. portfolio shifts, which are movements of money balances that already exist.

These three sources are at play in all markets, although in different degrees and proportions. As described in previous letters, the main force behind the U.S. bond market boom is massive money creation fuelled primarily by big bond purchases on the part of the Fed, and secondly, by banks and institutions playing the steep yield curve. The resulting bond purchases by these players (approximately $400 billion over the past two years) were crucial in forcing down U.S. long-term interest rates, and in turn, added considerable fire to the stock market boom.



However, the fact remains that liquidity as measured by the broad money aggregates and savings have grown only very slowly. So, apart from the liquidity growth in the financial system there is none — in fact there is a decline — elsewhere. Where then is the big impetus for the financial boom coming from? It's the third source mentioned above — an immense portfolio shift or asset reallocation away from cash (bank deposits) into securities. The salient point is that such a shift relates not only to the current increment of wealth or savings, but also to the whole stock of existing money holdings. Actually, this kind of shift occurs regularly at the bottom of the business cycle. But, never before has it occurred on such a stupendous scale as today.

THE TRASHING OF CASH

Today, an unprecedented panic stampede away from liquidity is unfolding. It is precisely this effect that explains the monetary mystery of a financial mania taking place in an environment of broad money stagnation. The graph above shows the enormity of the current portfolio shift on the balance sheet of U.S. individuals. For the first time on record there is a net outflow from deposits and money market funds. The rush into stocks, both direct and through mutual funds, is also the largest on record by far.

The self-evident problem with such a big portfolio shift is, of course, that it can't last. Besides causing significant excesses in securities markets — unsustainably high valuations and overspeculation — there is only so much money that can shift.

The big dash from cash has two causes. One is the result of the machinations of the Fed, more precisely, the pitifully-low yields that it has imposed on liquid assets. The second contributing cause is the determination of investors starved of income desperate to achieve returns above the inflation rate. Like sheep to the slaughter, they are unwittingly being driven into overspeculated securities markets. Unnerved by the prospect of prolonged economic sluggishness and rock-bottom short-term interest rates, they are loathe to remain in low-yielding assets.

All these facts are well-known and widely reported. What is conveniently ignored are the extremely negative liquidity consequences for private households and the economic and financial system overall. Consumer holdings of liquid assets are today no higher than four years ago and have fallen steeply as a share of total financial assets. As we showed in previous letters, overall liquidity (M4) is now the lowest in history as a share of total debt.

Concluding this part of our analysis, it's not an abundance of liquidity that is driving the worldwide financial mania but a panic-like escape from liquidity. Compounding it are the psychological effects of momentum. For a time, the spectre of rising securities prices simply begets higher prices. Rather than heralding the start of a new age of golden financial prosperity, we see a deceptive process under way that's luring many investors into certain financial disaster. What irritates us is not so much the behaviour of the ordinary investor but the complicity of the experts and economists who show no lack of ingenuity in spinning endless bullish yarns from a threadbare economic performance, the poorest in five decades.

TESTING THE ECONOMIC FORECASTS

Just how believable are all of the economic forecasts that underlie recent bullishness? According to the consensus, the U.S. economy is presently enjoying a well-balanced, relatively strong recovery. It's the third — if not fourth — surge in as many years. Each time it has triggered the same sanguine forecasts and each time it proved to be mistaken. What's different this time?

U.S. real GDP during the first three quarters of 1993 grew at an annual rate of 1.8%. Yet, consumer and business capital spending rose much more strongly at a rate of 3.8%. The big difference between the two were soaring imports which swallowed up about 40% of the increase in domestic demand. As such, imports have acted as a tremendous drag on the U.S. economy.

As a result, the current argument is that this latest rebound is very broad and is based upon strong gains in business capital spending, housing, consumption and consumer sentiment. Its most promising feature is seen in the two-year old business capital spending boom. Additionally, the wide publicity given to large-scale labour shedding and "restructuring" has given rise to the general assumption of superior productivity and profit gains, both currently and in the future. Understandably, this is sweet music for the stock markets.

Since we see the U.S. economy — and most other economies, for that matter — more in the grips of a structural crisis than in a cyclical recession, we're not so easily inclined to believe in such sudden beneficial developments. In assessing such trends, it's therefore very important to carefully distinguish between short-term cyclical and long-term structural changes. There is a general failure to make this basic distinction, consequently leading to gross misjudgments.

A PRODUCTIVITY MIRAGE AND PROFIT MYTH

It is true, as the consensus economists like to stress, that output growth during this past U.S recovery was largely due to sharply higher gains in productivity rather than employment. But that apparent productivity "miracle" is entirely attributable to substandard economic growth, not an above-average productivity performance. Over the first 10 quarters of recovery, GDP has grown 6.2%, (See Table I on the next page) or just one-half of the average output growth following previous postwar recessions since 1960. Productivity growth was no better — in fact it was slightly worse — than in previous cycles.

Quoting the OECD on this point (Economic Outlook, June 1993, p. 13): "*The evidence from the current recovery does not suggest productivity behaviour substantially different from that observed during previous recoveries. The predominance of productivity growth is due to the relative weakness of the recovery compared with output growth in previous upswings.*"

TABLE I: U.S. BUSINESS CYCLE COMPARISON

	NON-FINANICAL CORPORATE PROFITS			REAL GDP (1987)			REAL DISPOSABLE INCOME (1987)			OUTPUT PER NON-FARM MANHOUR			EMPLOYMENT		
EXPANSION PHASE (All calculations on a nearest quarterly basis.)	% Change After Recovery Start			% Change After Recovery Start			% Change After Recovery Start			% Change After Recovery Start			% Change After Recovery Start		
	1 Year	2 Years	10 Q's	1 Year	2 Years	10 Q's	1 Year	2 Years	10 Q's	1 Year	2 Years	10 Q's	1 Year	2 Years	10 Q's
Feb. 61 to Dec. 69	36.6%	42.3%	56.3%	6.4%	9.8%	13.2%	5.3%	8.3%	10.3%	4.7%	7.4%	9.8%	3.1%	5.0%	6.6%
Nov. 70 to Nov. 73	15.0%	32.3%	49.7%	2.3%	8.0%	12.4%	3.0%	7.3%	12.5%	2.2%	5.2%	8.5%	1.0%	4.6%	7.6%
Mar. 75 to Jan. 80	67.8%	62.2%	107.0%	6.4%	9.9%	13.3%	6.2%	7.9%	11.3%	4.8%	6.3%	7.6%	3.1%	6.3%	9.2%
Jul. 80 to Jul. 81	26.5%	N/A	N/A	3.0%	N/A	N/A	3.1%	N/A	N/A	2.0%	N/A	N/A	1.5%	N/A	N/A
Nov. 82 to Jul. 90	52.1%	83.5%	82.6%	5.1%	11.0%	12.4%	2.6%	9.7%	10.4%	2.5%	4.4%	4.4%	2.3%	6.9%	8.7%
Average of 4 (Ex. 80-81) Postwar Cycles Since 1961	42.9%	55.1%	73.9%	5.1%	9.7%	12.8%	4.3%	8.3%	11.1%	3.5%	5.8%	7.6%	2.4%	5.7%	8.0%
Mar. 91 to Sept. 93	8.4%	25.5%	36.1%	1.7%	5.0%	6.2%	2.2%	4.4%	6.2%	2.7%	4.9%	5.9%	-0.2%	1.1%	2.0%

Source: U.S. Department of Commerce

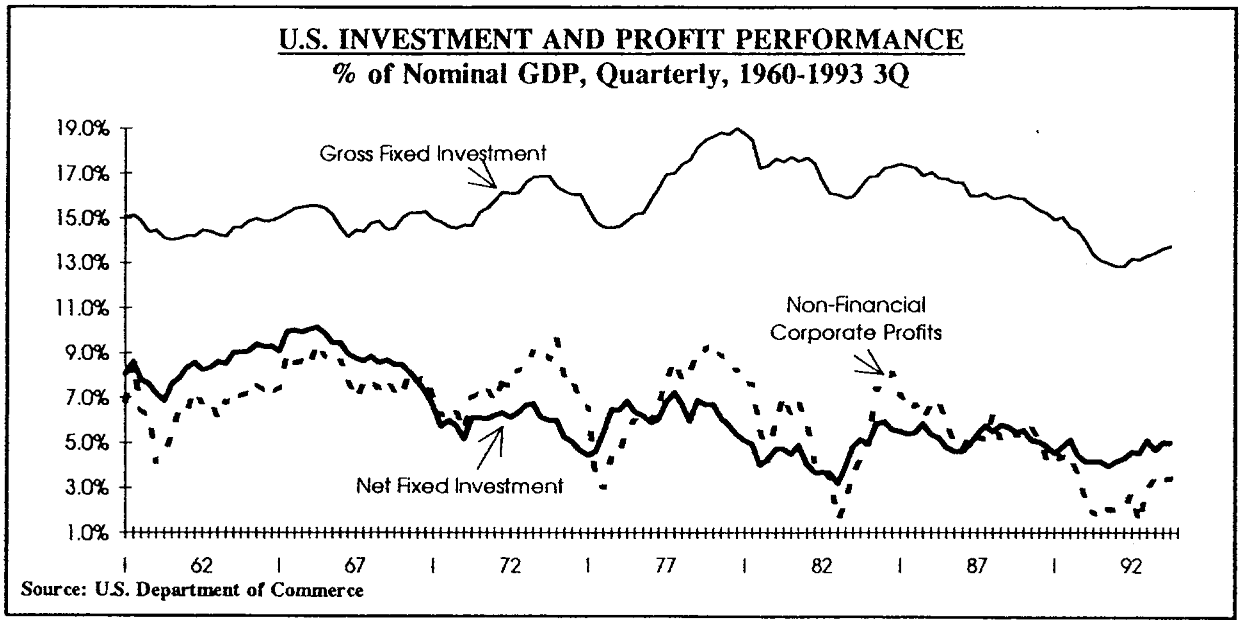
As well, we often read of a superb profit performance taking place in the U.S. Just as does productivity, business profits normally rise with a recovery. So, too, did profits this time but much less than in past recoveries. Non-financial corporate profits have only risen 36.1 % over the first 10 quarters of this recovery as compared to an average of 73.9% in past recoveries. Measured another way, in terms of GDP share, business profits have only recovered a third of the usual advance during this phase. In light of the huge profit gains attributable to the big non-recurrent benefit of an exceptionally steep fall in interest rates during recent years, the actual profit performance appears particularly poor.

In the same way, we have scrutinized the current U.S. economic recovery. Table I shows the results of some of the key comparisons — GDP growth, employment, and real disposable income. Over the 10 quarters of this recovery employment has risen 2.0% versus an average of 8.0% and income has only expanded 6.2% versus an average of 11.1%. We draw two conclusions: firstly, all improvements are purely of a cyclical variety and in no way are indicative of a secular turn of events; secondly, all the gains are grossly inferior to past cycles.

ADDRESSING THE LONG-TERM SECULAR PROBLEMS

The U.S. economy suffers from two interrelated macroeconomic maladies: first, that demand falls short of the economy's capacity to produce; and secondly, that productive capacity growth itself has sharply slowed due to inflated consumption. The counterpart to this latter problem is chronic, progressive underinvestment and a persistently large trade deficit. The chart on the opposite page captures the trends in investment and also explains why corporate profits remain anaemic. There's absolutely no indication of any long-term trend change.

Additionally, the graph highlights a telling discrepancy between gross and net investment. Net investment



has fallen much more steeply than gross investment. That's due to a major shift in investment from long-lived assets toward assets with short lives (for example computers). What it implies is that ever more gross capital formation is required to yield a net addition to the capital stock. Statistics recording investment and output growth are therefore artificially high relative to capacity growth.

The most striking and frightening part of this process is the inexorable shrinkage of the industrial base. During the 1960-70 period, U.S. industrial production rose 86% or 4.3% annually. At present, annual capacity growth of the manufacturing sector, as calculated by the Fed, is a lacklustre 1.6%. It's more a case of industrial anorexia than a hale expansion.

There is a two-edged consequence to this long-running underinvestment trend. Despite four years of very sluggish demand growth, the rate of industrial capacity utilization, now at 83%, is only two points short of its decade high of late 1988. The positive implication is a surprisingly small output gap. The negative reality, though, is that any strong recovery will quickly run into supply constraints, triggering inflation and soaring imports. Economic growth spurts are destined to short-circuit very early.

A HOLLOW INVESTMENT BOOM

Recent U.S. recovery forecasts now trumpet the perception that an investment boom will take the lead from liquidity in driving the stock market upward. Stock markets will now become earnings-driven as opposed to liquidity-driven. According to many reports, the U.S. economy is fast breaking out of its chronic investment stupor.

Others, including the OECD, have qualified the current U.S. rebound as being investment-led, pointing to a double-digit surge in business capital spending on plant and equipment, the strongest in decades. Before we can join the jubilation, we need to look underneath these surface statistics. An entirely different and shocking story emerges.

Old European business cycle theory — the guiding principles to our analytical work — ascribes the leading cyclical role to investment spending. Its regular steep cyclical rebound produces a strong credit expansion and, through the so-called multiplier process, strong employment and income growth. For us, the present prolonged economic sluggishness in the OECD countries is the direct result of a collapse in investment spending and the multiplier process working in reverse.

TABLE II: U.S. CYCLICAL INVESTMENT TRENDS

	TOTAL FIXED INVESTMENT			RESIDENTIAL FIXED INVESTMENT			PRODUCER DURABLE EQUIPMENT			NON-RESIDENTIAL STRUCTURES		
EXPANSION PHASE (All calculations on a nearest quarterly basis.)	% Change After Recovery Start			% Change After Recovery Start			% Change After Recovery Start			% Change After Recovery Start		
	1 Year	2 Years	10 Quarters	1 Year	2 Years	10 Quarters	1 Year	2 Years	10 Quarters	1 Year	2 Years	10 Quarters
Feb. 61 to Dec. 69	8.4%	12.6%	21.0%	11.4%	18.8%	29.8%	13.4%	17.4%	25.5%	-0.5%	-0.2%	5.2%
Nov. 70 to Nov. 73	8.3%	19.8%	30.7%	34.5%	52.6%	63.1%	-0.4%	7.8%	23.5%	-1.8%	1.0%	6.0%
Mar. 75 to Jan. 80	7.8%	20.3%	28.3%	25.2%	47.3%	63.5%	1.8%	15.1%	19.8%	-0.6%	0.7%	5.3%
Jul. 80 to Jul. 81	5.2%	N/A	N/A	6.5%	N/A	N/A	3.7%	N/A	N/A	6.2%	N/A	N/A
Nov. 82 to Jul. 90	11.8%	28.6%	31.9%	55.4%	67.1%	66.5%	5.9%	25.7%	28.9%	-9.3%	6.6%	12.6%
Average of 4 (Ex. 80-81) Postwar Cycles Since 1961	9.1%	20.3%	28.0%	31.6%	46.5%	55.7%	5.2%	16.5%	24.4%	-3.1%	2.0%	7.3%
Mar. 91 to Sept. 93	1.7%	12.9%	17.7%	13.7%	29.1%	29.2%	1.5%	17.5%	25.9%	-9.5%	-12.3%	-10.5%

Source: U.S. Department of Commerce

Is the U.S. economy really breaking out of its investment stupor? No, it is not. During the first three quarters of 1993, U.S. real fixed investment rose $52 billion or at annual rate of 8.8%. Over the first 10 quarters of the recovery since early 1991, investment only rose a cumulative 17.7% and compares poorly with an average 28% rise during previous cyclical recoveries (See Table II above). Far from being exceptionally strong, seen in this light, the investment recovery is exceptionally weak. Of key importance to us are the cyclical demand and employment effects of current capital spending.

Consider this: Of the 1993 increase in investment, 62% was accounted for by information equipment, mostly computers. On the other extreme was building and production machinery which only rose minimally. Traditionally, building plays a huge role in the investment upswing. But forging further into this investigation quickly brought Mark Twain's famous quip to mind about "*...lies, bloody lies, and statistics.*" The statistic that utterly begged our credulity in this regard was the discovery that 40% of U.S. real GDP growth during 1993 was attributable to computer investment. How is that possible?

In the first nine months of 1993, total spending on computers increased $9 billion. That's rather small in terms of the overall economy and doesn't look like much of a boom. The statisticians, however, calculated that the actual computational power buyers received for this money, due to the large declines in prices, was actually worth $27.7 billion. It was this greater amount that was added, literally padding GDP.

That's three times the nominal spending amount and now represents a large portion of real GDP growth. But what are the actual employment and income effects of this? One needs a microscope to find them. The computer manufacturing industry accounts for 2.6% of total manufacturing output and 7/100ths of

one percent of the total non-farm workforce. Owing to fabulous productivity gains, this industry is able to boost its output while at the same time reducing its employment and slashing prices. Statistically, it's an investment boom but economically, nobody feels it.

GAUGING THE STRENGTH OF THE U.S. RECOVERY

How really strong is the U.S. recovery? Oddly, the answer depends critically on the evaluation of the computer boom and its leverage effects on employment and incomes. Since the end of 1989, investment in computers and peripherals accounted for 20.5% of real U.S. GDP growth. Of this, 81% is explained by the price adjustments. ~~They raise U.S.~~ business spending on equipment close to a 23-year high as a share of real GDP. On a nominal basis, spending on equipment is near a 23-year low.

In the end, the alleged investment- and productivity-led recovery rests on nothing more than a vision of the future, for example, what new trends and fads might take over from the current restructuring and computer-investment boom. However, we are not futurologists, but economists. As European theory propounds, what matters solely in the short run of a recovery are the leverage effects on employment, incomes and purchasing power resulting from the production of the capital goods.

The computer industry has only a minute impact in this regard. The most important sector in this regard is construction which possesses every attribute that generates a self-reinforcing recovery. It is capital-, credit-, employment- and income-intensive. And it is precisely this sector that has the weakest performance. (See Table II on page 10). In this light, both the investment boom and real growth are grossly overstated.

We are led to this conclusion: The present U.S. recovery lacks any ingredient that could make it self-sustaining, let alone self-reinforcing. As long as consumer income growth stays weak, the temporary borrowing binge is bound to fade. Personal savings already have fallen to near all-time lows. We expect that U.S. economic growth will decelerate sharply to a virtual crawl in the coming months.

A COMMODITY SCARE?

A related conclusion is that inflationary expectations in the U.S. are misplaced. Convinced by the coincidence of production constraints and a perceived investment boom, inflation fears have been rising. But this notion misses two crucial points: firstly, that the computer investment boom, being readily met by soaring productivity gains and imports, is not at all prone to overheating the economy; and secondly, any stronger rise in U.S. domestic demand is promptly swallowed by rising imports because the rest of the world has mountains of unused capacity. If anything, the U.S. economy's Achilles heel is the balance of payments and the dollar, not the domestic inflation rate.

In conclusion, neither in the United States nor anywhere else do we see convincing evidence of a sustainable economic recovery. While downturns do level off eventually, the world economy is still likely to get weaker. This forecast is a direct outflow of the observation that there is an unmitigated slump in world investment.

Sustained, strong recoveries are ushered in by surging investment spending that in turn bring forth the typical big expansions of bank credit and broad money. These are the three key interlocking parts of the business cycle. In the main industrial world, all three of them are as dead as mutton.

CONCLUSIONS

1994 has begun on a note of false hope and wishful thinking. There are great expectations that a genuine world economic recovery will begin. The main reason why this won't happen is the continuing worldwide slump in investment with its progressive contractive effects on employment and incomes. Profits will generally fall.

As our research concludes, both the U.S. economy and the dollar have most probably peaked.

Stock markets around the world are overspeculated, overvalued and therefore extremely vulnerable to disappointments. By far, we are witnessing the greatest financial market mania since the 1920s.

Weakening economies in 1994 stand to shock and shake the stock markets. Is another crash possible? Considering the disastrous liquidity trend that we described which is observable around the world, it already seems predetermined to us. The only question is the timing.

Contrary to the comforting counsel of conventional economists, events will show that politicians and central banks, despite their best intentions, will be unable to prevent the coming financial fallout.

Investors will be fortunate to preserve their money in 1994. Investment prospects are skimpy. Certainly, there is little value to be found in stock markets anywhere.

Investors should avoid overspeculated markets at all costs. For security, it's best to focus on short-term cash securities and shorter-term bonds of the hard currency countries — Germany, the Netherlands, Switzerland and Austria.

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